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Self- Employment Tax

For use in preparing
1994 Returns

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Important Change

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings remains the same for 1994 and 1995. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for 1994 is \$60,600. For 1995, that amount increases to \$61,200. For 1994 and 1995, there is no maximum amount subject to the Medicare part.

Introduction

This publication explains what income is subject to self-employment tax and how to figure the amount of self-employment tax.

The self-employment tax is a social security and Medicare tax for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of wage earners.

Useful Items

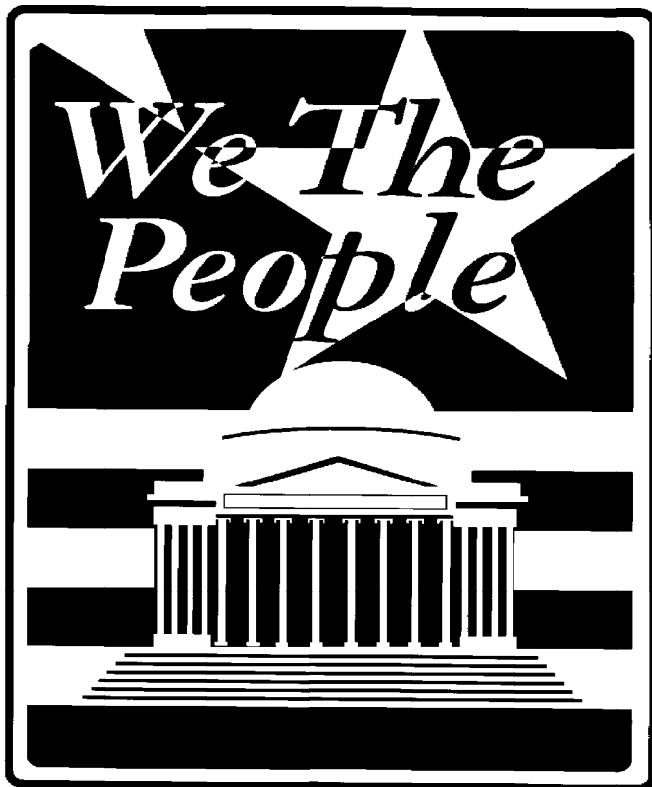
You may want to see:

Publication

- ☐ **225** Farmer's Tax Guide
- ☐ **505** Tax Withholding and Estimated Tax
- ☐ **517** Social Security and Other Information for Members of the Clergy and Religious Workers
- ☐ **541** Tax Information on Partnerships
- ☐ **911** Tax Information for Direct Sellers
- ☐ **937** Employment Taxes

Form (and Instructions)

- ☐ **1040** U.S. Individual Income Tax Return
- ☐ **Sch C (Form 1040)** Profit or Loss From Business
- ☐ **Sch C-EZ (Form 1040)** Net Profit From Business
- ☐ **Sch EIC (Form 1040A or 1040)** Earned Income Credit



Ordering publications and forms. To order free publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address.

Telephone help. You can call the IRS with your tax question Monday through Friday during regular business hours. Check your telephone book for the local number or you can call toll-free **1-800-829-1040**.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call **1-800-829-4059** with your tax question or to order forms and publications. See your tax package for the hours of operation.

General Information

The following information on social security benefits and coverage, and on reporting the self-employment tax, may be helpful.

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of self-employment tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

You must be *insured* under the social security system before you begin receiving social security benefits (described above). You are insured if you have the required number of quarters of coverage. A "quarter of coverage" means a period of 3 calendar months during which you were paid a certain amount of income subject to social security tax.

For 1994, you receive a quarter of social security coverage, up to four quarters, for each \$620 (\$630 for 1995) of income subject to social security. Therefore, for 1994, if you had income of \$2,480 that was subject to social security taxes (self-employment and wages), you will receive four quarters of coverage.

For an explanation of the number of quarters of coverage you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security number. You must have a social security number to pay self-employment tax. If you do not have a number, you should apply for one on Form SS-5, *Application for a Social Security Card*. You can get this form at any Social Security office.

If you have a social security number from the time you were an employee, you should not apply again.

If you had a number but lost your card, you should file Form SS-5 showing where and

about when you first applied for it. You will get a card showing your original number, not a new one.

Estimated tax. You may be required to pay estimated tax. This depends on how much income and self-employment taxes you expect for the year and how much of your income will be subject to withholding tax.

If you are also an employee, you may be able to cover your estimated income and self-employment tax payments by having your employer increase the amount of income tax withheld from your pay.

You may have to pay a penalty if you do not pay the correct installment of estimated tax by its due date. For more information, see Publication 505.

Reporting self-employment tax. Figure your self-employment tax on Schedule SE. Then report the tax on line 47 of Form 1040, and attach Schedule SE to Form 1040.

Self-employment tax deduction. You can deduct one-half of your self-employment tax as a business expense in figuring your adjusted gross income. This is an income tax adjustment only. It does not affect either your net earnings from self-employment or your self-employment tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the "Deduction for one-half of self-employment tax" line of the Schedule SE.

Who Must Pay Self-Employment Tax

If you carry on a **trade or business**, except as an employee, you probably have to pay self-employment tax on your self-employment income. A trade or business is generally an activity carried on for a livelihood or in good faith to make a profit. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business. Regularity of activities and transactions and the production of income are important elements.

The facts and circumstances of each case determine whether or not an activity is a trade or business. For example, see *Fishing crew members* under *Self-Employment Income*, later.

The self-employment tax rules apply even if you are fully insured under social security or have started receiving benefits.

Statutory employees. If you earned wages as a statutory employee, the box titled "Statutory employee" in box 15 of Form W-2, *Wage and Tax Statement*, will be checked. A statutory employee should file a separate Schedule C (or Schedule C-EZ) to report only the income and expenses related to his or her earnings as a statutory employee. However, a statutory employee does not have to pay the self-employment tax on those earnings because social security and Medicare taxes (FICA

taxes) are withheld. If you have no other earnings from self-employment, you do not have to file Schedule SE.

If you have wages as a statutory employee in addition to earnings from self-employment, do not include the wages in net profit on Schedule SE.

Income limits. You must pay self-employment tax if you have net earnings from self-employment of \$400 or more. You must also pay self-employment tax if you are paid \$108.28 or more in a year as an employee of a church or qualified church-controlled organization that elected exemption from social security and Medicare taxes. However, see *Religious Exemptions*, later.

For 1994, the maximum amount subject to the social security part (12.4%) is \$60,600. All earnings from self-employment are subject to the Medicare part of the tax.

Self-Employment Income

You are probably self-employed if you are a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

Some types of income, such as interest, may or may not be self-employment income. The source of your income and your involvement in the activity from which your income is received will determine whether it is self-employment income. Different kinds of self-employment and other income are discussed below.

Aliens. Resident aliens are generally subject to the same rules as U.S. citizens. Nonresident aliens do not pay self-employment tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. For self-employment tax purposes, they are not nonresident aliens.

Nonresident and resident aliens employed in the United States by an international organization, a foreign government, or a wholly owned instrumentality of a foreign government are not subject to self-employment tax.

Gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring self-employment income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion. For example, gains or losses from the disposition of the following types of property are not included:

- 1) Investment property.
- 2) Depreciable property or other fixed assets used in your trade or business.

- 3) Livestock held for draft, dairy, breeding, or sporting purposes and not held primarily for sale, regardless of how long the livestock were held or whether they were raised or purchased.
- 4) Standing crops sold with land held more than one year.
- 5) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.

A gain or loss from the cutting of timber is not included if the cutting is treated as a sale or exchange.

Dealers in options and commodities. Dealers in options and commodities must treat as net earnings from self-employment gains and losses from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options), or property related to such contracts, such as stock used to hedge options. See sections 1256 and 1402(i) of the Internal Revenue Code.

Dividends. Dividends on securities are not self-employment income unless you are a dealer in securities.

Executor or administrator. When you administer a deceased person's estate, your fees are earnings from self-employment if you are:

- 1) A professional fiduciary,
- 2) A nonprofessional fiduciary (personal representative), and:
 - a) The estate includes an active trade or business that you actively participate in, and
 - b) Your fees are related to the operation of that trade or business, or
- 3) A nonprofessional fiduciary of a single estate that requires extensive managerial activities on your part for a long period of time, provided these activities are enough to be considered a trade or business.

A nonprofessional fiduciary reports fees that are earnings from self-employment on Schedule C or C-EZ. If the fees are not earnings from self-employment, report them on line 21 of Form 1040.

Fishing crew members. Certain members of the crew on a boat that catches fish or other water life are self-employed if:

- 1) They do not get any money for their work (other than their share of the catch or of the proceeds from the sale of the catch),
- 2) They get shares of the catch or shares of the proceeds from the sale of the catch,
- 3) Their shares depend on the amount of the catch, and
- 4) The operating crew usually numbers less than ten individuals.

Crew members who meet these conditions are considered self-employed and must pay self-employment tax and generally need to make estimated tax payments.

Example 1. Mike Jones, an owner of a fishing boat of more than 10 net tons, employs a captain and eight others to work as crew members on the boat. The proceeds from the sale of the catch offset boat operating expenses, including bait, ice, and fuel. 60% of the balance is divided among the captain and the crew members and 40% between Mike and the captain.

Between voyages, the crew members do not receive any additional compensation, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch. However, the mate, the engineer, and the cook get an additional payment from Mike of \$100 each. The payment does not depend upon the boat's catch. Since the mate, the engineer, and the cook get this additional payment that does not depend on the amount of the catch, they are not considered self-employed. The \$100 payment and their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

Since the other six crew members, including the captain, do not get any additional pay and are members of an operating crew of fewer than 10 members, they are considered self-employed. Mike does not have to withhold federal income tax or social security and Medicare taxes from their pay. They must pay self-employment tax on their earnings.

Example 2. The facts are the same as in Example 1, except that, in addition to receiving a share of the catch, the captain and the other crew members are entitled to get \$10 per hour for repairing nets, constructing new nets, splicing cable, and other incidental work while in port. Since the crew members are entitled to receive payment other than a share of the catch, they are not considered self-employed. The \$10 per hour payment plus their share of the proceeds from the catch are subject to federal income tax withholding, social security and Medicare taxes, and the federal unemployment tax.

Independent contractor. People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, etc., who follow an independent trade, business, or profession in which they offer their services to the general public are generally not employees. However, whether such people are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not the means and methods of accomplishing the result. Income earned by an independent contractor is self-employment income.

You are not an independent contractor if you perform services that can be controlled by an employer (what will be done and how it will

be done). If an employer-employee relationship exists (no matter what the relationship is called), you are not an independent contractor.

For more information in determining whether you are an independent contractor or an employee, get Publication 937, *Employment Taxes*.

Interest. Interest is not self-employment income unless you receive it in your trade or business. This includes interest on accounts receivable or from bonds, notes, etc., if you are a dealer in stocks or securities.

Lost income payments. If you are self-employed and reduce or stop your business activities, any payment you receive for the lost income of your business from insurance or other sources is self-employment income. If you are not working when you receive the payment, it still relates to your business (even though it is temporarily inactive) and is self-employment income.

If there is a connection between any payment you receive and your trade or business, the payment is self-employment income. A connection exists if it is clear that the payment would not have been made but for your conduct of the trade or business.

Newspaper carriers. The wages newspaper carriers receive for delivering newspapers or shopping news to customers is not self-employment income. If the carriers are 18 or over, the wages are subject to withholding for social security and Medicare taxes (FICA taxes).

However, if a carrier is 18 or over and works under an arrangement in which the carrier's pay is the difference between a fixed sales price and the cost of the newspapers to the carrier, the income is self-employment income.

Newspaper vendors. The income newspaper vendors receive for selling newspapers or magazines directly to customers for a profit is not self-employment income if the vendor is under age 18. However, if the vendor is 18 or over, the income is self-employment income.

Part-time business. Income from an activity you carry on part-time is self-employment income. For example, in your spare time you fix televisions and radios. You have your own shop, equipment, and tools. You get your customers from advertising and word-of-mouth. The income you earn from your repair shop is self-employment income.

Public officials. Public officials generally do not pay self-employment tax on what they earn in their official positions. Public office includes any elective or appointive office of the United States or its possessions, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

Payments received by an elected tax collector from state funds on the basis of a fixed percentage of the taxes collected is not income from self-employment.

However, public officials of state or local governments must pay self-employment tax

on their fees if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal-state agreement.

Real estate agents and direct sellers. Income received by a licensed real estate agent or a direct seller may be self-employment income. A licensed agent or direct seller generally is treated as self-employed if:

- 1) Substantially all remuneration paid for services as a real estate agent or direct seller is directly related to sales or other output rather than hours worked, and
- 2) The services are performed under a written contract that provides that the agent or seller will not be treated as an employee for federal tax purposes.

For more information, see Publication 937 and Publication 911.

Real estate rent. Rent from real estate and personal property leased with real estate is not self-employment income. However, if you receive rent as a real estate dealer, include the rental income and related deductions in figuring self-employment income.

Hotels, apartments, etc. Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate if services are provided for the occupants. These rental payments are included in figuring net income from self-employment. Services generally are provided for the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms for occupancy only. Maid service, for example, is a service provided for the convenience of the occupants. However, heat and light, the cleaning of stairways and lobbies, and the collection of trash are not.

Trailer park owners. Rent received by trailer park owners who provide trailer lots, facilities, and services is rent from real estate. It is not included in self-employment income unless the services provided by the owners are substantial and for the convenience of tenants. Providing services, such as city sewerage, electrical connections, and roadways, are services required to maintain space for tenant occupancy and not services for the convenience of tenants. Although the operation and maintenance of a trailer park laundry facility is a service provided for the convenience of tenants, it is not, by itself, substantial.

If, however, the owners provide services for tenants that are beyond those required for occupancy and are substantial in nature, the owner's earnings are included in self-employment income. Services for tenants that are beyond those required for occupancy include supervising and maintaining a recreational hall provided by the park; distributing a monthly newsletter to tenants; operating a laundry facility; and helping tenants buy or sell their trailers.

Research grants. If you receive payments under a research grant from a governmental

foundation but you are not under the control of either the grantor foundation or the grantee institution, you are an independent contractor. The payments you receive are self-employment income.

Retired insurance agents. The income paid by insurance companies to retired insurance agents that is based on a percentage of commissions received prior to retirement is self-employment income. Also, the income for renewal and deferred commissions for sales made prior to retirement is self-employment income.

However, renewal commissions paid to the survivor of an insurance agent is not self-employment income.

Sole proprietor. If you own and operate your own business as a sole proprietor, the income from your business is self-employment income. If your spouse works with you in your business, see *Partners*, later.

U.S. citizens working in U.S. for foreign government or international organization. If you are a U.S. citizen employed in the United States by a foreign government, a wholly owned instrumentality of a foreign government, or an international organization, you are subject to the self-employment tax if your employer does not deduct social security and Medicare taxes from your income.

International social security agreements. The United States has social security agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, you must generally pay social security and Medicare taxes to only the country you live in.

The United States now has social security agreements with the following countries: Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Additional agreements are expected in the future. For more information, contact:

Social Security Administration
Office of International Policy
P.O. Box 17741
Baltimore, MD 21235

U.S. possession self-employment income. Self-employment income from activities in a U.S. possession is subject to self-employment tax, even if your possession income is exempt from U.S. income tax.

Form to file. If you are required to file Form 1040, report all of your self-employment income on Schedule SE. This is true even if your possession income is not otherwise reported on Form 1040. If you are not required to file Form 1040, use Form 1040-SS (or Form 1040-PR if appropriate) to report your self-employment income. The following are treated as U.S. possessions:

Guam
American Samoa

The Virgin Islands

The Commonwealth of the Northern Mariana Islands

Puerto Rico (may file either Form 1040-PR or Form 1040-SS)

For more information on U.S. citizens in U.S. possessions, see Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*.

Wages, salaries, and tips. Wages received for services performed as an employee and covered by social security or railroad retirement are not self-employment income. Tips received for work done as an employee are also excluded from self-employment income.

Corporate Payments

Whether income received from a corporation is self-employment income depends on the reason for the payment.

Corporate director. Fees received for performing services as a director of a corporation are self-employment income. It does not matter whether the fees are for going to directors meetings or for serving on committees.

Corporate employee. Even if you own most or all of the stock of a corporation, your income as an employee or officer of the corporation is not self-employment income.

S corporations. If you are a shareholder in an S corporation, your share of the corporation's taxable income is not self-employment income, even though you include it in your gross income for income tax purposes.

If you are a shareholder and also an officer of an S corporation and perform substantial services, you are an employee of the S corporation. Your payment for services is subject to withholding for social security and Medicare taxes and is not self-employment income, no matter what the S corporation calls the payments.

Partners

If you are a member of a partnership that carries on a trade or business, your distributive share of its income or loss from the trade or business is included in your income from self-employment. Guaranteed payments from your partnership should be included, along with your share of earnings or losses, when you figure your net earnings from self-employment.

For information on partnerships, see Publication 541.

Inactive partner. An inactive partner figures income from self-employment by including the distributive share of partnership income or loss and any guaranteed payments.

Limited partner. A limited partner figures self-employment income by excluding the distributive share of partnership income or loss. But guaranteed payments, such as salary and

professional fees received for services performed during the year, are included as self-employment income.

Retired partner. A retired partner pays no self-employment tax on retirement income received from the partnership under a written plan if:

- 1) The retired partner receives life-long periodic payments,
- 2) The retired partner's share of the partnership capital was fully repaid to the retired partner,
- 3) The retired partner performs no services for the partnership during the year, and
- 4) The partnership owes the retired partner nothing but the retirement payments.

Husband and wife partners. You and your spouse may operate a business as a partnership. If you and your spouse join together in the conduct of a business and share in the profits and losses, a partnership has been created. You and your spouse must report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income and file separate Schedules SE (Form 1040) to report each partner's self-employment tax.

However, if your spouse is not your partner but rather your employee, you must pay social security and Medicare taxes for him or her. For more information, see Publication 937.

Investment club partnership. A member's share of income from an investment club partnership is not self-employment income if the club limits its activities to:

- 1) Investing in savings certificates, stock, or securities, and
- 2) Collecting interest or dividends for its members' accounts.

In this situation, the partnership is not engaged in a trade or business.

Different tax years. If your tax year is not the same as your partnership's, report your share of partnership income or loss on your return for the year that includes the end of the partnership tax year.

Example. You file your return on a calendar year basis, but your partnership uses the fiscal year ending January 31. You must include on your return for calendar year 1994 your distributive share of partnership earnings and your guaranteed payments for the fiscal year ending January 31, 1994.

Death of a partner. When a partner dies, his or her distributive share of partnership income (or loss) is figured through the end of the month in which the death occurs. This is true even though the decedent's estate or heirs may succeed to rights in the partnership. The partnership income for the year is treated as though earned in equal amounts each month.

Example. ABC Partnership operates a business. Its tax year ends on December 31. A partner dies on August 18. The deceased partner's (and his or her estate's) distributive share of partnership income for the year of death is \$12,000. That partner's self-employment income from the partnership is \$8,000 (8/12 of \$12,000).

Religious Exemptions

Ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty may get an exemption from self-employment tax on certain earnings. To get the exemption, they must file Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*.

Members of religious orders who have taken a vow of poverty are automatically exempt for amounts received while working for a church or an integral agency of the church. However, amounts received for performing services for an organization other than the church cannot be exempted from the tax.

For more information on getting an exemption, see Publication 517.

Members of recognized religious sects opposed to insurance. If you belong to a recognized religious sect that is opposed to insurance, you may qualify for an exemption from the self-employment tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, retirement, or medical care, or provides services for medical care. If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based on sect teachings is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

To get the exemption, you must file an application, Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*, and waive all social security benefits.

Employee of a church or church-controlled organization. If you work for a church or a qualified church-controlled organization that elected exemption from social security taxes, you will have to pay self-employment tax if you are paid \$108.28 or more in a year by the church or organization.

However, you can elect to be exempt from social security taxes if you are a member of a qualifying religious sect. See *Members of recognized religious sects opposed to insurance*, above. Both you and your employer must receive approved applications for exemption from social security coverage before the exemption can take effect. Employees use Form 4029 to apply for an exemption.

Net Self-Employment Income

Net self-employment income usually includes all business income less all business deductions allowed for income tax purposes.

You must determine your net income from self-employment by using the same accounting method you use for income tax purposes. You must claim all allowable deductions when figuring net self-employment income. Your net self-employment income is reduced by 7.65%, as explained later, to determine your net earnings from self-employment. Making false statements to get or to increase social security benefits may subject you to penalties.

Your net self-employment income is shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C-EZ (Form 1040), line 36 of Schedule F (Form 1040), and line 15a of Schedule K-1 (Form 1065).

More than one business. If you have more than one trade or business, you must combine the net income from each business to determine your net self-employment income. A loss you incur in one business will reduce your gain in another business. Net these gains and losses for purposes of the self-employment tax. Keep separate records for each business and file the appropriate form or schedule for each separate business.

Example. You are the sole proprietor of two separate businesses. You operate a restaurant that made a net profit of \$25,000 last year. You also have a cabinetmaking business that had a net loss of \$500 last year. You file Schedule SE showing net self-employment income of \$24,500. You must also file a Schedule C for each business—a Schedule C for the restaurant showing your net profit of \$25,000, and another Schedule C for the cabinetmaking business showing your net loss of \$500.

Church employee. If you are an employee of a church or church-related organization that elected exemption from social security and Medicare taxes, your net self-employment income is the gross income you received for your services, without any deductions.

Recaptures and credits. If you recaptured any depreciation, including any section 179 deduction, because the business use of certain property was reduced to 50% or less, these recaptured amounts are subject to the self-employment tax. This does not include amounts recaptured on the disposition of property. For more information, see the instructions for Part IV of Form 4797, *Sales of Business Property*.

If you claimed the targeted jobs credit, use your reduced wage and salary expense deduction to determine your net self-employment income.

Deductions and exemptions. Your self-employment income should not be reduced by certain deductions you used to figure income tax. Specifically, do not use:

- 1) Deductions for personal exemptions for yourself, your spouse, or dependents,
- 2) The standard deduction or itemized deductions,
- 3) The net operating loss deduction,
- 4) Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing, annuity plan, Keogh or SEP plan, and
- 5) The self-employed health insurance deduction.

Caution: The self-employed health insurance deduction expired for tax years beginning after 1993. However, as this publication was being prepared for print, Congress was considering legislation to extend this deduction. For information on late legislative changes, see Publication 553, *Highlights of 1994 Tax Changes*.

Example. You own a grocery store that had the following items for the year:

| | |
|---|----------|
| Gross profit on sales | \$87,400 |
| Salaries | 30,000 |
| Rent | 6,000 |
| Heat, light, and air conditioning | 2,400 |
| Other expenses | 1,900 |
| Gain on refrigerator sale | 350 |
| Fire loss on store building | 1,200 |
| Net operating loss carryover | 1,000 |

To figure taxable income, consider all the above items. But to figure **net self-employment income**, use only the following:

| | |
|---|------------------------|
| Gross profit on sales | \$87,400 |
| Expenses: | |
| Salaries | \$30,000 |
| Rent | 6,000 |
| Heat, light, and air conditioning | 2,400 |
| Other expenses | 1,900 |
| Total expenses | <u>40,300</u> |
| Net operating profit | <u>\$47,100</u> |

The \$47,100 is your net self-employment income. The refrigerator sale, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation.

Figuring Self-Employment Tax

There are three steps to figure the amount of self-employment tax you owe.

- 1) Determine your net earnings from self-employment.
- 2) Determine the amount that is subject to the tax.
- 3) Multiply that amount by the tax rate.

There are three ways to figure net earnings from self-employment.

- 1) The regular method,

- 2) The farm optional method, and
- 3) The nonfarm optional method.

The tax rates are the same for net earnings figured under each method. You will find the general rules for figuring self-employment tax in the discussion of Schedule SE, later.

Optional methods. The optional methods (discussed later) allow you to continue social security coverage when you have a loss or small amount of net income from self-employment (see *How the optional methods can help you*, later).

Tax rates. The self-employment tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). However, you can take a deduction of 7.65% of your net self-employment income when figuring your net earnings from self-employment. You are allowed this deduction only in figuring self-employment tax, and you figure it on line 4 of your 1994 Schedule SE. This is **not** the same as the deduction for one-half of self-employment tax taken on Form 1040, line 25.

Fiscal-year taxpayer. If you use a tax year other than the calendar year, you must use the tax rate and maximum income limit in effect at the beginning of your tax year. Even if the tax rate or maximum income limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Minimum income. You must have \$433.13 or more of net self-employment income before reduction by the 7.65% deduction to be subject to the tax ($.9235 \times \$433.13 = \400). If your net income is less than \$433.13 before the 7.65% reduction, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you choose to use an optional method listed earlier.

Maximum income. No more than \$60,600 of your combined wages, tips, and net earnings in 1994 is subject to any combination of the 12.4% social security part of self-employment tax, social security tax, or railroad retirement tax.

All of your combined wages, tips, and net earnings in 1994 are subject to any combination of the 2.9% Medicare part of self-employment tax, social security tax, or railroad retirement tax.

If your wages and tips are subject to either social security or railroad retirement tax, or both, and total at least \$60,600, you do not have to pay the 12.4% social security part of the self-employment tax. However, you must pay the 2.9% Medicare part of the self-employment tax on all of your net earnings.

How the optional methods can help you. Either or both of the optional methods may help you if you have little income or a loss from self-employment and:

- 1) You want to receive credit for social security benefit coverage,
- 2) You incurred child or dependent care expenses for which you could claim a credit

(this method will increase your earned income which could increase your credit), or

- 3) You are entitled to the earned income credit (this method will increase your earned income which could increase your credit).

Effect on taxes. If you use either or both optional methods, you must figure and pay the self-employment tax due under these methods, even if you would have had a smaller tax or not tax using your actual self-employment income or loss under the regular method.

The optional methods may be used only to figure your self-employment tax. To figure your income tax, include your actual self-employment income in gross income, regardless of which method you use to figure self-employment tax.

Forms. Use Schedule SE (Form 1040) to figure your self-employment tax. Report the self-employment tax on line 47 of Form 1040. If you have to pay self-employment tax, you must file a Form 1040 (with Schedule SE attached) even if you are not otherwise required to file a federal income tax return.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has self-employment income, it is independently subject to the self-employment tax and should be reported on a separate Schedule SE. If you file a joint return and you both have self-employment income, each of you must complete a separate Schedule SE (Form 1040); attach both schedules to the joint return. See *Husband and wife partners*, earlier, under *Partners*.

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to self-employment tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

Schedule SE

You must file Schedule SE if:

- 1) You were self-employed, and your net earnings from self-employment from other than church employee income were \$400 or more, or
- 2) You had church employee income of \$108.28.

Even if you are not required to file Schedule SE, it may be to your benefit to file it and use either optional method in Part II of Section B.

Most taxpayers can use *Short Schedule SE* (Section A) to figure self-employment tax. However, the following taxpayers must use *Long Schedule SE* (Section B):

- 1) Individuals whose total wages and tips subject to social security (or railroad retirement) tax plus net earnings from self-employment are more than \$60,600,
- 2) Ministers, members of religious orders, and Christian Science practitioners not taxed on earnings from these sources (with IRS consent) who owe self-employment tax on other earnings,
- 3) Employees who earned wages reported on Form W-2 of \$108.28 or more working for a church or church-controlled organization that elected exemption from social security taxes,
- 4) Individuals with tip income subject to social security (or railroad retirement) and Medicare taxes that was not reported to their employers, and
- 5) Individuals who use one of the optional methods to figure self-employment tax.

Regular Method

Use the following steps to figure self-employment tax.

Step 1. Figure your net self-employment income. The net profit from your business or profession is generally your net self-employment income. See *Net Self-Employment Income*, earlier.

Step 2. After you figure your net self-employment income, determine how much is subject to self-employment tax. This net income is reduced by the 7.65% deduction to arrive at net earnings from self-employment.

7.65% deduction. Multiply your net income by 0.9235 for the 7.65% deduction ($100\% - 7.65\% = 92.35\%$ or 0.9235). This is your net earnings from self-employment.

Step 3. Figure your self-employment tax as follows.

- 1) If your net earnings from self-employment plus any wages and tips are not more than \$60,600, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply your net earnings by the 1994 tax rate of 15.3% (.153). The result is the amount of your self-employment tax.
- 2) If you had no wages, your net earnings from self-employment are more than \$60,600, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply the line 4 net earnings by the 2.9% (.029) Medicare tax and add the result to \$7,514.40 (12.4% of \$60,600). The total is the amount of your self-employment tax.
- 3) If your net earnings from self-employment plus any wages and tips are more than \$60,600, you must use *Long Schedule SE*. Subtract your total wages and tips from \$60,600 to find the maximum amount of earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4%

(.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your self-employment tax.

Example 1. During 1994, you have \$30,000 in net self-employment income and receive no wages subject to social security and Medicare taxes. You multiply the \$30,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction ($100\% - 7.65\% = 92.35\%$), and the result is \$27,705. Your self-employment tax is 15.3% (0.153) of \$27,705, or \$4,238.87.

Example 2. During 1994, you have \$20,000 in net self-employment income and receive \$15,000 in wages subject to social security and Medicare taxes. You multiply the \$20,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is \$18,470. Your self-employment tax is 15.3% (0.153) of \$18,470, or \$2,825.91.

Example 3. During 1994, you have \$70,000 in net self-employment income and receive no wages subject to social security and Medicare taxes. You multiply the \$70,000 by 0.9235 on *Short Schedule SE* for the 7.65% deduction, and the result is \$64,645. Since only \$60,600 of your earnings is subject to the social security part of the self-employment tax, your tax for this part is \$7,514.40 (12.4% of \$60,600).

Since all of your net earnings are subject to the Medicare part of the self-employment tax, multiply \$64,645 by 2.9% (.029) on *Short Schedule SE* for the Medicare part, and the result is \$1,874.71. Add this to \$7,514.40 and your self-employment tax is \$9,389.11.

Example 4. During 1994, you have \$70,000 in net self-employment income and receive \$10,000 in wages subject to social security and Medicare taxes. You multiply the \$70,000 by 0.9235 on *Long Schedule SE* for the 7.65% deduction, and the result is \$64,645. Next, you subtract your wages of \$10,000 from \$60,600, the maximum income subject to the social security part of the self-employment tax. The result is \$50,600. Since only \$50,600 of your earnings is subject to the social security part of the self-employment tax, your tax for this part is 12.4% (.124) \times \$50,600, or \$6,274.40.

Since all of your net earnings are subject to the Medicare part of the self-employment tax, you multiply all of your net earnings from self-employment, \$64,645, by 2.9% (.029) on *Long Schedule SE* for the Medicare part, and the result is \$1,874.71. Add this to the \$6,274.40 figured above for total self-employment tax of \$8,149.11.

Nonfarm Optional Method

By using the nonfarm optional method, you can continue your self-employment tax coverage when your net profit for the year is small or you have a loss. But you may not use this method to report an amount less than your actual net earnings from self-employment.

Use the nonfarm optional method only for self-employment income that does not come from farming. You may use this method if you meet all the following tests.

- 1) Your net nonfarm profits as shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C-EZ (Form 1040), and line 15a of Schedule K-1 (Form 1065), are less than \$1,733.
- 2) Your net nonfarm profits are less than 72.189% of your gross nonfarm income.
- 3) You are self-employed on a regular basis. This means that your actual net earnings from self-employment were \$400 or more in at least 2 of the 3 tax years before the one for which you use this method.
- 4) You have not previously used this method more than 4 years (there is a 5-year life-time limit). The years do not have to be one after another.

Gross Income of \$2,400 or Less

If your gross income from all nonfarm trades or businesses is \$2,400 or less and you meet the four tests in the preceding paragraph, you may report two-thirds of the gross income from your nonfarm business as net earnings from self-employment.

Example 1. Ann Green had actual net earnings from self-employment of \$800 in 1992 and \$900 in 1993 from her craft business. She thus meets the test for being self-employed on a regular basis. Her earnings in 1994 are as follows:

| | |
|--------------------|---------|
| Gross income | \$2,100 |
| Net profits | \$1,200 |

Because her actual net profits are less than \$1,733 and less than 72.189% of her gross nonfarm income, Ann may either use her actual net earnings or she may use the optional method to report \$1,400 (two-thirds of \$2,100).

Example 2. Assume that in Example 1 Ann has a gross income of \$1,000 and her net profits are \$800. She must use her actual net profits. She may not use the optional method because her actual net profits are not less than 72.189% of her gross income.

Example 3. Assume that in Example 1 Ann has a net loss of \$700. In this situation, she may use \$1,400 (two-thirds of \$2,100) as her net earnings under the optional method.

Example 4. Assume that in Example 1 Ann has a gross income of \$525 and net profits of \$175. In this situation, she would not pay any self-employment tax under either the regular method or the optional method because she would not meet the minimum income requirement of \$400.

Gross Income of More Than \$2,400

If your gross income from all nonfarm trades or businesses is more than \$2,400 and you meet the four tests for using the nonfarm optional method, you may report \$1,600 as your net earnings from nonfarm self-employment.

Example 1. John White runs an appliance repair shop. His net earnings from self-employment in 1991 were \$8,500; in 1992, \$10,500; and in 1993, \$9,500. He thus meets the test for being self-employed on a regular basis. His earnings in 1994 are as follows:

| | |
|--------------------|----------|
| Gross income | \$12,000 |
| Net profits | \$ 1,200 |

Because his net profits are less than \$1,733 and less than 72.189% of his gross nonfarm income, John may either use \$1,600 as his net earnings from self-employment, or he may report \$1,200 under the regular method.

Example 2. Assume that in Example 1 John's net profits are \$1,800. He must use the full \$1,800 figured under the regular method. He may not use the optional method because his actual net nonfarm profits are not less than \$1,733.

Example 3. Assume that in Example 1 John has a net loss of \$700. He may use the optional method and report \$1,600 as his net earnings from self-employment.

Figuring the Tax

After you determine your net earnings from self-employment under the nonfarm optional method, check to see whether your earnings meet the minimum income requirement of \$400. If they do, multiply the net earnings figure by the 1994 tax rate (15.3%). The result is the amount of self-employment tax you owe.

Farm Optional Method

If you are in the farming business, either as an individual or as a partner, you may be able to use the farm optional method to figure your net earnings from farm self-employment. Like the nonfarm method, this method also allows you to continue self-employment coverage when your net profit for the year is small or you have a loss.

There are fewer restrictions for using this method than for using the nonfarm optional method. There is no test of regular self-employment nor is there a requirement that your actual net farm profits be less than 72.189% of your gross income. There is also no limitation on the number of years you may use this method.

Gross income of \$2,400 or less. If your gross income from farming is \$2,400 or less, you may report two-thirds of your gross income as your net earnings from farm self-employment.

Gross income of more than \$2,400. If your gross income from farming is more than \$2,400 and your actual net farm profits are less than \$1,733, you may report \$1,600 as your net earnings from farm self-employment. But if your gross income from farming is more than \$2,400 and your actual net farm profits are \$1,733 or more, you cannot use the optional method.

Gross Income From Farming

Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. This includes income in the form of crop shares if you materially participate in production or management of production.

If you receive government commodity program payments on land you rent out, do not include these payments unless you meet the material participation test. For more information, see Publication 225.

Cash method of accounting. If you file your return on the cash method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 11 of Schedule F.

Accrual method of accounting. If you file your return using an accrual method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 51 of Schedule F.

Gross income from a farm partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farm partnership:

- 1) Figure the partnership's gross income from farming.
- 2) Subtract any guaranteed payments to partners for services or the use of capital if the payments are determined without regard to partnership income.
- 3) Determine your share of what is left. The gross income that remains after steps one and two is divided among the partners in the same way they share the ordinary income or loss of the partnership unless the partnership agreement provides otherwise.

The result determined in (3) above is your distributive share of the partnership's gross income from farming. If you have no other gross income from farming, including guaranteed payments discussed next, use this distributive share of gross income to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Guaranteed payments. Any guaranteed payments you receive from a farm partnership that are determined without regard to partnership income are gross income from your farming (not the partnership's). Use the total of these payments, your distributive share of gross income from a farm partnership, and any other gross income you receive from farming, to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Figuring the Tax

If your net earnings from self-employment under the farm optional method are \$400 or more, multiply the net earnings figure by the tax rate for 1994 (15.3%). The result is the amount of self-employment tax you owe.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual earnings, you can still use the farm optional method. For example, your actual net earnings from self-employment are \$425 and your net earnings figured under the farm optional method are \$390. You owe no self-employment tax if you use the optional method, since your net earnings are below \$400.

Using Both Methods

You may not combine income from farming with nonfarm income to figure your net earnings under either of the optional methods. If you use both optional methods, you must add together the net earnings figured under each method to arrive at your total net earnings from self-employment. You may report less than actual total net earnings but not less than actual net earnings from nonfarm self-employment alone when using both methods. If you use both optional methods, you may report no more than \$1,600 as your combined net earnings from self-employment.

Example 1. You are a self-employed farmer. You also operate a retail grocery store. Your 1994 gross income, actual net earnings from self-employment, and optional farm and optional nonfarm net earnings from self-employment are as follows:

| | Farm | Nonfarm |
|-------------------------|---------|---------|
| Gross income | \$1,200 | \$1,500 |
| Net earnings | 900 | 500 |
| % of gross income | 800 | 1,000 |

You may figure your 1994 net earnings from self-employment in any of the four combinations shown below:

| | 1 | 2 | 3 | 4 |
|-------------------------------|----------------|----------------|----------------|-----------------|
| Actual farm net earnings | \$ 900 | — | \$ 900 | — |
| Optional farm net earnings | — | \$ 800 | — | \$800 |
| Actual nonfarm net earnings | 500 | 500 | — | — |
| Optional nonfarm net earnings | — | — | 1,000 | 1,000 |
| Net earnings | <u>\$1,400</u> | <u>\$1,300</u> | <u>\$1,900</u> | <u>\$1,600*</u> |

*Limited to \$1,600 because both the farm optional and the nonfarm optional methods are used.

Example 2. Assume that in Example 1 your gross income, actual net earnings from

self-employment, and optional farm and optional nonfarm net earnings from self-employment are as follows:

| | <u>Farm</u> | <u>Nonfarm</u> |
|-------------------|-------------|----------------|
| Gross income | \$2,600 | \$1,000 |
| Net earnings | 400 | 800 |
| % of gross income | 1,733 | 667 |

Your 1994 net earnings from self-employment may be either of the amounts figured below:

| | <u>1</u> | <u>2</u> |
|-------------------------------|----------------|----------------|
| Actual farm net earnings | \$ 400 | — |
| Optional farm net earnings | — | \$1,600* |
| Actual nonfarm net earnings | 800 | 800 |
| Optional nonfarm net earnings | — | — |
| Net earnings | <u>\$1,200</u> | <u>\$2,400</u> |

*Limited to \$1,600.

You may not use the nonfarm optional method for 1994 because your actual net earnings from nonfarm self-employment (\$800) are not less than 72.189% of gross nonfarm income ($.72189 \times \$1,000 = \721.89).

Example of Schedule SE

Susan J. Brown is sole proprietor of a dress shop, "Milady Fashions." Her Schedule C (Form 1040) shows a net profit of \$35,100 in 1994. Her completed Schedule SE (Form 1040) with *Short Schedule SE* filled out is shown on the next page.

If Susan were the sole proprietor of more than one business, she would have combined the profits and losses from all of them and completed only one Schedule SE. If, in addition to operating her dress shop, she had worked for wages and the total of her wages and her self-employment income was more than \$60,600, she would have filled out *Long Schedule SE*.

Susan's Schedule SE does not have her husband's name on it. Since her husband has no interest in her business, he does not pay self-employment tax on this income. If her husband has self-employment income of his own, he will file a separate Schedule SE.

The line numbers shown below in bold type refer to the line numbers on the sample filled-in *Short Schedule SE* on the next page.

Line 1. Since Susan has no farm income, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, \$35,100.

Line 3. Since Susan has no farm income, she enters the same amount on line 3.

Line 4. Susan multiplies the \$35,100 by 0.9235 for the 7.65% deduction and enters \$32,414.85.

Line 5. Susan now figures her self-employment tax. She multiplies the \$32,414.85 on line 4 by the tax rate (15.3%) on line 5. She enters this amount, \$4,959.47, on line 5. This is the amount of self-employment tax she owes. She enters the amount on line 47 of Form 1040.

Line 6. She multiplies \$4,959.47 on line 5 by .50. She enters \$2,479.74 here and on Form 1040, line 25.

SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service (T)

Self-Employment Tax

▶ See instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

OMB No. 1545-0074

1994

Attachment
Sequence No. 17

Name of person with self-employment income (as shown on Form 1040)

Susan J. Brown

Social security number of person
with self-employment income ▶

123 00 6789

Who Must File Schedule SE

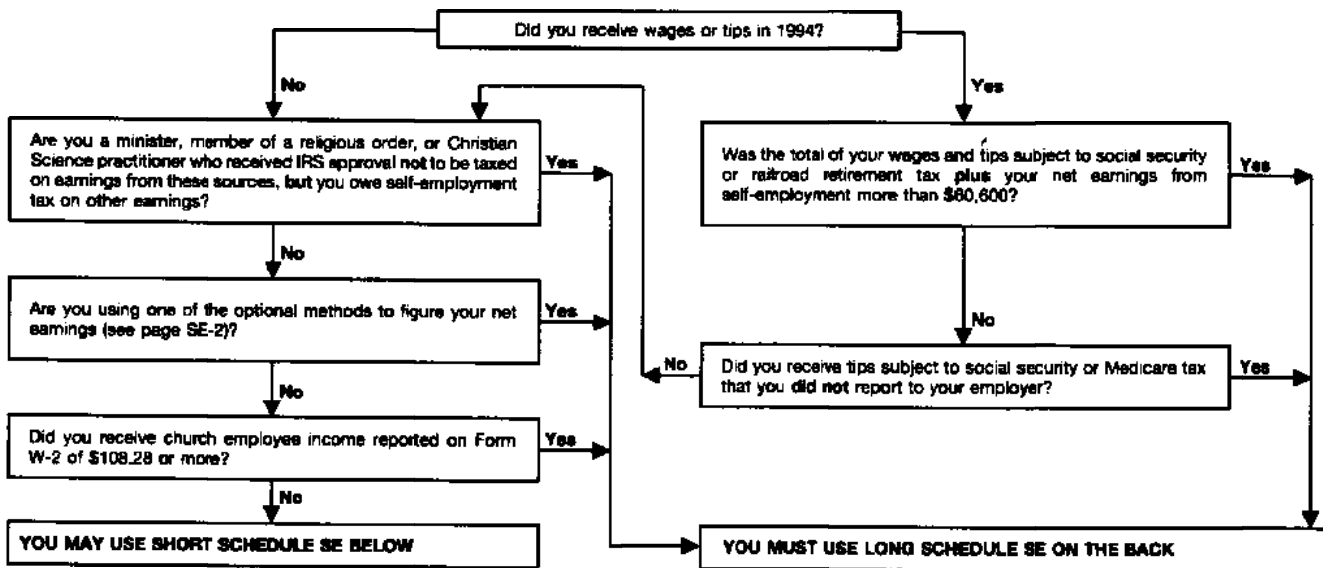
You must file Schedule SE if:

- You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, **OR**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is **not** church employee income. See page SE-1.

Note: Even if you have a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-2.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner, and you filed Form 4361 and received IRS approval not to be taxed on those earnings, do not file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 47.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

- 1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a
- 2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report
- 3 Combine lines 1 and 2
- 4 **Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶
- 5 **Self-employment tax.** If the amount on line 4 is:
 - \$60,600 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 47.
 - More than \$60,600, multiply line 4 by 2.9% (.029). Then, add \$7,514.40 to the result. Enter the total here and on Form 1040, line 47.
- 6 **Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25

| | | | |
|---|--------|----|--|
| 1 | | | |
| 2 | 35,100 | 00 | |
| 3 | 35,100 | 00 | |
| 4 | 32,414 | 85 | |
| 5 | 4,959 | 47 | |
| 6 | 2,479 | 74 | |

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 1994

